

Equity Research

North America

United States of America

Telecom - Wireline

SBC Communications Inc.

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STRONG BUY

Price (December 18, 2000): \$53.31

Price Target: \$60

52-Week Range: \$59 - 34.81

WHAT'S CHANGED

Change of Target Price: \$66 to \$60

Earnings (2000): From \$2.27 to \$2.26

Earnings (2001): From \$2.62 to \$2.53

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Change in Earnings Forecast

December 20, 2000

Lower Estimates; Selloff Brings Attractive Entry Point

- SBC issued new and lower guidance for 2001, with revenue and EPS growth below our numbers, and lowered DSL subscriber expectations. Revenues should grow 8-9% in '01, EPS should increase 11-14% in '01, and DSL subs should be around 760K for year-end 2000.
- The company highlighted three factors driving the new guidance: 1) regulatory delays with long distance market entry, 2) AIT service issues which have slowed DSL rollout and increased costs, and 3) general economic slowdown.
- We have lowered our estimates to reflect the new guidance. Our new 2001 EPS estimate is \$2.53, versus our prior estimate of \$2.62. Based on our new numbers, the shares are at a 19% discount to the S&P500.
- We reiterate our Strong Buy rating. We believe the selloff creates an attractive entry point. However, we have lowered our target price to \$60 (from \$66) based on our lower estimates.

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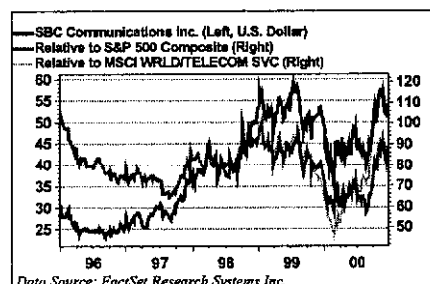
Date

7/18/01

Reporter

AUC

Price: Abs. and Rel. To Market & Industry



Company Description

SBC operates location exchange networks in the southwestern and midwestern United States and provides cellular and personal communication services in the northeastern, midwestern and southwestern United States.

| FY ending Dec 31: | 1999A | 2000E | 2001E | 2002E |
|------------------------------|-----------|-------|-------|-------|
| EPS (\$) | 2.15 | 2.26 | 2.53 | 2.86 |
| Prior EPS Ests. (\$) | - | 2.27 | 2.62 | 2.98 |
| Consensus EPS Ests. (\$) | - | - | - | - |
| CEPS (\$) | 2.21 | 2.37 | 2.66 | 3.00 |
| P/E | 24.8 | 23.6 | 21.1 | 18.6 |
| P/E Rel. to (local index) | - | - | - | - |
| P/CE | 24.1 | 22.5 | 20.0 | 17.8 |
| Price/Book | 6.9 | 5.8 | 5.0 | 4.3 |
| EV/EBITDA | 9.6 | 9.0 | 8.1 | 7.2 |
| Yield (%) | 1.8 | 1.9 | 1.9 | 2.0 |
| Market Cap (\$ m) | 180,461 | | | |
| Enterprise Value (\$ m) | 200,815.3 | | | |
| Debt/Cap (09/00) (%) | 35.1 | | | |
| Return on Equity (09/00) (%) | 26.7 | | | |
| L-T EPS Grth ('yy - 'yy) (%) | 13.3 | | | |
| P/E to Growth | 1.77 | | | |
| Shares Outstanding (m) | 3,385.0 | | | |

E = Morgan Stanley Dean Witter Research Estimate

Please refer to important disclosures at the end of this report.

Lower Estimates; Selloff Brings Attractive Entry Point

Summary and Investment Conclusion

Following its annual planning process, SBC issued new and lower guidance for 2001. It now expects 2001 revenue growth (including proportionate Cingular revenues) of 8-9%, versus prior guidance of double digit revenue growth. Earnings growth should also come in lower than expected, at 11-14%, versus prior guidance of mid-teens growth. The company attributed the new guidance to three major factors. First, long distance entry will be slower than expected due to regulatory delays. As new markets for the national expansion strategy are targeted for rollout in tandem with long distance entry, the SBC Telecom CLEC initiative also will be slowed (by six months), which will impact original revenue growth targets. The second major factor is the Ameritech region, where alleviation of service issues will be more costly than expected, and DSL deployment has been delayed. The third factor, according to the company, is the general softening of the economy, although not much detail was given in this area.

Accordingly, we have lowered our numbers to reflect the new guidance. The table below shows our old and new estimates.

| | Old MSDW | New MSDW |
|------------------------|-----------|-----------|
| Revenues | | |
| 2000E | \$53.3 bn | \$53.2 bn |
| 2001E | \$58.7 bn | \$57.5 bn |
| Revenue growth | | |
| 2000E | 8.7% | 8.6% |
| 2001E | 10.2% | 8.0% |
| EPS | | |
| 2000E | \$2.27 | \$2.26 |
| 2001E | \$2.62 | \$2.53 |
| EPS growth | | |
| 2000E | 5.6% | 5.1% |
| 2001E | 15.4% | 11.9% |
| DSL Subscribers | | |
| 2000E | 900K | 760K |
| 2001E | 2,460K | 1,839K |

Selloff Creates Attractive Entry Point

SBC shares faced tremendous pressure following the announcement, trading down 13% most of the day, and we believe this would be an attractive entry point for new investors in the stock. Based on our revised 2001 estimates, and assuming a soft landing for the market (9% growth in 2001 for S&P500 EPS), SBC currently trades at about 18 times earnings, or a 19% discount to the S&P500. However, assuming a hard landing (3% decline in S&P500 EPS in 2001), current levels would represent a 28% discount to the market.

Lowering Target Price, but Reiterate Strong Buy

We reiterate our Strong Buy rating. We have lowered our target price to \$60 from \$66. This is based on 21 times our new lowered 2002 EPS estimate of \$2.86 (versus our prior target which was equal to 22 times 2002E EPS of \$2.98). While the revised guidance is a setback, we believe the company's new expectations are reasonably conservative. SBC remains a major player in the data and local broadband sector, has the strongest balance sheet in the industry, and screens very favorably versus its peers on a cash-flow generation basis.

Slower DSL Rollout Than Expected In Ameritech Region

SBC indicated that it has been installing 3,500-4,000 new DSL subscribers per day in the fourth quarter. This represents over twice the installation rate of 3Q00. However, this is a definite disappointment, given that the company had expected to exit the fourth quarter installing 7,000-8,000 per day. It appears that the Ameritech region is the major factor. Due to service quality issues, SBC has been unable to aggressively rollout DSL service -- translating into about 37% of its territory in a basic sales blackout. We were pleased to hear the company indicate that the demand side of the equation remains healthy, especially in the Southwestern Bell and Pacific Bell territories. A second negative factor was deployment of DSL to remote terminals, which was delayed until late in the third quarter due to regulatory issues.

That said, we have lowered our DSL forecasts for SBC... as well as for the industry. We now believe the company will report total DSL subs of about 760K for year-end 2000. This compares to our prior estimate of 900K, as well as the original company target of one million subscribers. SBC

also indicated that it does not plan to ramp its DSL installation rate in the first half of 2001. We believe the company likely will add just under 1.1 million subs next year, for a total of about 1.8 million subscribers. With lower rollout expectations from the CLECs, we have also lowered our total industry DSL forecast. We believe total industry DSL subscribers should come in around 5.4-5.5 million subscribers in 2001, versus our prior forecast of over 6 million.

Regulatory Delays for LD Approvals

Beyond Texas, the company indicated that long distance entry approval has been slower than expected, which will impact prior revenue growth targets. SBC targets five additional states for entry by year-end 2001: Kansas, Oklahoma, Missouri, Arkansas, and California. FCC approval is pending in Kansas and Oklahoma, and the company targets September 2001 for California approval. On Friday, the California PUC said it would rule on the application on May 24, 2001. The company believes that these five states together represent \$21.3 billion opportunity, with California representing \$15 billion alone. (Please reference our recent note, "Bell LD Entry Grinds Slowly Forward" for further details.)

Ameritech Region Service Issues Remain Priority

SBC indicated that service quality issues in the Ameritech region have continued, and the company expects to spend an additional \$200 million or more to make further improvements. Importantly, the issues are not core plant-related (e.g., trunking or switching), but rather seem to be the result of lack of maintenance and capacity in the outside plant. The company has added 2,000 employees to service the region. SBC highlighted that it will fulfill its pledge to

bring Ameritech service levels up to the same standards as SBC's own territory, but indicated that additional spending will be necessary to institutionalize this effort.

Further Guidance

The company reiterated capex guidance of flat spending in 2001 compared to 2000. SBC also said that it expects to generate better returns on invested capital in 2001 versus 2000. Finally, the company indicated that after 2001, it should return to mid-teens earnings growth. SBC has been proactive in repurchasing its own shares, and has repurchased 47 million year-to-date. The limit of 140 million shares permitted to be repurchased as required by the Ameritech merger terms will expire in October 2001.

What Does This Mean for the Industry?

Following SBC's announcement, all three of the major ILECs traded down at least 5%. We believe that much of the issues in the company's announcement were broadly specific to SBC itself and should not be interpreted to belie a trend for the overall industry. Of the major factors driving the company's new guidance, we believe that the Ameritech issues are by far the most significant and will raise expenses, as well as put pressure on revenue growth due to delays in both DSL deployment and LD entry. The two non-specifically-Ameritech factors -- California long distance entry and a general slowing of the economy -- are less company-specific. All other indications from the company signaled that strong fundamentals remain intact, with data revenue growth expected to stay north of 30%, strong wireless growth, and only moderate impacts from competition.

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SBC Communications Inc. - December 20, 2000

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